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Richard J. Williams, Director
State Corporation Commission
Division of Economics and Finance
1300 East Main Street
Richmond, Virginia 23218

Dear Mr. Williams:

Please find enclosed responses to the questions for the 2nd Annual Report to the Legislative Transition Task Force ("LTTF"). If you should have any questions please feel free to contact me at (502) 627-4136.

Yours very truly,

A handwritten signature in cursive script that reads "F. Howard Bush" with a stylized "mlg" or similar mark below it.

F. Howard Bush
Manager, Regulatory Compliance

Enclosure



Q1. What are the most significant obstacles to the development of a robust competitive retail electricity market for residential customers? For commercial and industrial customers? How can these obstacles be overcome?

The most significant obstacles to the development of competition in the residential or any other market sector is the reluctance of jurisdictions to release generation to the market. With the view that generation should be retained for the incumbent's customers, jurisdictions limit the development of the robust market. Only a national policy setting guidelines for everyone, all states, public and private producers, can truly result in the competitive market.

Another obstacle to the development of a robust competitive retail electricity market for residential customers appears to be lack of need. A competitive marketplace will thrive not because of legislation but because of economics. If the economics for a competitive marketplace exist, and market participants believe they have an opportunity to either reduce costs or increase revenues, then they will participate in the market; if they do not believe these opportunities exist, they will not participate.

Rapid implementation of a competitive marketplace is not necessarily the best course. The restructuring act does not recognize that one-size fits all approach is not necessarily reasonable. Kentucky Utilities Company ("KU"), d/b/a Old Dominion Power in Virginia, is in a unique situation with regard to the other electric providers in the Commonwealth. KU serves only 29,500 customers in southwestern Virginia. KU's rates for service are the lowest in Virginia and among the lowest in the nation. KU is not interconnected with any other utility in Virginia and, as such, would necessitate access by Virginia based CSP's through multiple transmission systems. In addition, the movement to competition is progressing very slowly in Kentucky where the vast majority of KU's customers reside. Because of this, it is unlikely that KU's Virginia customers would opt for or benefit from choice of generation supplier. KU is extremely concerned that it is being required to comply--and spend substantial sums to do so-- with enabling regulations that do not recognize the unique situation of its customers.

- Q2. Last year, several parties that submitted recommendations on how to facilitate competition emphasized the importance of RTOs to the development of an efficient market. In particular, RTOs were seen as critical to resolving the issues of transmission constraints and market power. The establishment of RTOs is proceeding at a slower pace than many expected. Is it necessary for RTOs to be properly functioning before an effective competitive market is a possibility in the Commonwealth? How can Virginia assist competitive suppliers to enter the market in the absence of fully functional RTOs?

It is not a prerequisite for RTOs to be properly functioning before an effective competitive market can develop in more urban parts of Virginia. However, there may be certain efficiencies to be gained by delaying the full implementation of retail competition until wholesale competition and standard market design initiatives are more fully implemented. While the RTOs are designed to address market and reliability matters at the wholesale level for an entire region (i.e. multiple states), the methods utilized by the RTOs for tariff design, congestion management, market monitoring and mitigation, dispute resolution, and transition periods may prove useful to the Commonwealth for replication at the retail level. Thus, while not necessary, it may be beneficial for the Commonwealth to delay advancement of retail competition until the establishment and operation of RTOs have proceeded to a point of sufficient maturity to provide guidance for the retail level.

- Q3. The Federal Energy Regulatory Commission recently issued a paper titled "Working Paper on Standardized Transmission Service and Wholesale Electric Market Design." In that paper the FERC observed that it "must restructure electric transmission service to provide comparability for all sellers of electricity, use transmission assets more efficiently, and reduce inefficiencies by standardizing market rules. This should be done by creating a new, flexible transmission service to be offered by all transmission providers to all customers, with a new standard market design for wholesale electric markets." Is it necessary to have a functioning power exchange with policies and procedures that are consistent with a standard market design in order to have effective competition in Virginia? If so, what are the essential elements of a standard market design?

It is not necessary to have a functioning power exchange with policies and procedures that are consistent with a standard market design in order to have effective competition in Virginia. However, there are certain efficiencies that a standard market design implementation at the wholesale level may provide for a more effective retail competition program. FERC has announced its intention to issue the Notice of Proposed Rulemaking on Electricity Market Design and Structure by the summer of 2002. While the working papers have indicated some of the issues that FERC expects to address in the NOPR--including the implementation of Locational Marginal Pricing for congestion management and a new, single type of transmission service--the comments filed in the Standard Market Design ("SMD") docket indicate that there is no industry consensus on what the SMD NOPR should require. The wide spectrum of issues to be included in the NOPR indicates that a significant amount of uncertainty exists regarding the ultimate form and content of the NOPR. Thus, while not necessary, it may be more effective for the Commonwealth to delay advancement of retail competition until the rulemaking is complete.

- Q4. Are the Commission's Rules Governing Retail Access to Competitive Energy Services conducive to promoting effective competition in the Commonwealth? If not, how should they be modified? Is there any way in which these rules can or should be improved, in any event?

The Commissions Rules governing Retail Access to Competitive Energy Services are not conducive to promoting effective competition in the Commonwealth. Current Rules increase burdens on the current utilities; according to the Virginia Restructuring Act, rates are capped until 2007. Rate caps are a form of competitive handicapping where the rules are restrictive, thus increasing regulation and not promoting competition; therefore this deprives consumers of the full range of marketplace choices and limits the ability of the incumbent utility to respond quickly to the changing market.

- Q5. It has been suggested by one of Virginia's competitive suppliers that it is "unfortunate the state [Virginia] is buying advertising to educate citizens about electricity shopping where there isn't any market to speak of". (Restructuring Today, April 17, 2002). Is the SCC's Virginia Energy Choice consumer education program on target, or should it be scaled back until market activity picks up?

The question regarding the Commission's education program should be answered in light of another question: what is the objective of the education program? If the Commission believes that customers should be educated about the specific alternatives available to them, to potentially reduce their electric bills by shopping in the competitive marketplace, then the education program should be scaled back until such a marketplace materializes. If the Commission believes that the objective of the program is to educate citizens about the overall structure of the competitive program in the Commonwealth, to bring awareness to citizens of the steps taken by the Legislature and the Commission, and, to provide the customers with flexibility to meet their energy needs, then the education program need not be scaled back.

Q6. What policies regarding aggregation and aggregators would promote the development of effectively competitive retail electricity markets in Virginia?

The policies regarding aggregation and aggregators are sufficient, provided competition actually exists.

- Q7. Upon shopping customers return to capped rate service provided by local distribution companies, should these returning customers have the option of paying a “market-based” price (or another alternative pricing option) instead of capped rates as a means of avoiding any applicable minimum stay requirements?

If the shopping based customers choose to voluntarily cancel their energy service with their local distribution company, and acquire service from a competitive energy service provider, then leave the CSP (for any reason) prior to the minimum stay requirement, the customer should be charged the higher cost or market. The SCC should determine the default service provider based on the most competitive proposal made to the commission. If the default service provider is determined through this process, it will allow participants, including the local utility, to bid to a default rate that is essentially a function of the market and more likely sufficient to recover the actual cost or increase in providing default service. Otherwise the utility will be bound to the traditional bundled service rate, which then could be grossly insufficient to cover the actual cost incurred in providing default bundled service to those customers taking service under default service tariffs.

- Q8. Some potential competitors have suggested that the projected market prices for generation developed by the Commission in establishing wires charges under § 56-583 should reflect a retail market price rather than a regional wholesale market price. Please comment on this.

Since everyone is required to pay wire charges regardless of the supplier of the generation, the competitor must beat the “market” for its customers to have an advantage.

- Q9. In a recent Richmond Times Dispatch article concerning retail choice and the absence of measurable competitor activity in service territories currently open to retail choice, competitive suppliers reportedly identified wires charges as a significant barrier to competitive entry in the Virginia generation market. Please comment on that assertion.

Wires charges are not seen as a barrier to competition or to entry into the competitive generation market. The justification for unbundling is to separate charges by function so that the functions may be accurately compared. Everyone pays wires charges regardless of who supplies the generation. Competition related to the generation function is independent of anything else in an unbundled environment.

- Q10. Last year in its response to Commission Staff inquiries about facilitating effective competition, Allegheny Power recommended a concept titled “The Fund.” This would be a mechanism whereby rate caps could be incrementally increased to facilitate market development, thus creating “head room” for competitive offers. To the extent that an incumbent utility received revenues in excess of its rate cap, a fund would be established that could be used to reduce potential post-transition rate shock, subsidize demand response programs, and/or subsidize public benefit programs. Please comment on this suggestion.

We believe that the market should develop independently of any rate cap restrictions. Periodically increasing capped rates to create “head room” for competitive offers will distort current market conditions. The key to a robust competitive market is not to restrict local utilities to protect competitors. Where the costs to initiate retail competition is not prohibitive given the likely customer response, retail competition should bring consumers the benefits of lower prices, better products and innovative technology, if market participants are treated equally. Market participants are treated equally by making competition subject to the same rules, which are based on the principles of fair choice and efficiency.

Q11. LG&E Energy suggested last year in its response to Commission Staff inquiries about facilitating effective competition that there should be no price caps. Please comment on this suggestion.

Price caps have no place in an open market. In order to have an active market the competitors must be able to respond to variable conditions. To limit their ability to do so introduces a risk some will view as unacceptable. This will restrict their entry into the market. The premise behind deregulation is that with an open market, the market will provide its own cap with the competitors driving prices down.

Q12. Is there a role for regulation in the promotion of demand-side participation, whereby customers are provided the means to receive price signals and adjust their demand during high-cost periods?

KU believes that there is a role for regulation in the promotion of demand response programs. KU cautions, however, that mandatory demand response programs will distort the market and lead to inefficiencies. The FERC has discussed demand response programs as part of the SMD initiative. LG&E/KU provided comments in the FERC SMD workpaper proceeding, stating that the demand response programs should be subject to state rather than federal authority. LG&E/KU urged the FERC to obtain consensus of the state commissions on the demand response provisions. The key elements for state-approved demand response programs are (1) voluntary participation, (2) the timely, uninterrupted reception of price signals to the customer and (3) the ability of the customer to actively and rapidly respond to the price signal. Regulation can play a part in the implementation of demand response programs to the extent that the regulator reviews the proposed programs with an awareness of the need for these three basic elements for program success.

Q13. Virginia's electric cooperatives are exempted by statute from certain Restructuring Act provisions. For example, (i) cooperatives are not required to provide CSP consolidated billing (§ 56-581.1 J of the Restructuring Act); (ii) default service in cooperatives' service territories cannot; as a matter of course, be put out to competitive bid (§ 56-585 F of the Restructuring Act); and (iii) Virginia's electric cooperatives are permitted under § 56-231.34:1 of the cooperative act to make direct, unregulated sales of electric power within their service territories without having to form affiliates to do so (this would appear to permit cooperatives to selectively discount generation prices on a customer-by-customer basis). In light of these exemptions, how should competitor entry into cooperatives' service territories be encouraged and facilitated?

Assuming the costs of initiating competition is reasonably related to the likely customer response to competition, competition into cooperative service territories should be encouraged and facilitated like any other true competitive market. Competitive markets exist in part due to the economies of scale. If the economics for a competitive marketplace exist and market participants believe that they have an opportunity to either reduce costs or increase revenues, then they will participate in the market, if they do not believe the opportunities exist, they will not participate.

- Q14. Several states have enacted or are considering incentives to foster competitive activity. Please comment on the following:
- a. There is a legislative proposal pending in Rhode Island to give cities and towns the ability to shop for their residents. Under this proposal, residents would automatically be switched to a locality's choice of electricity supplier unless they "opted out" in order to stay with their incumbent utility. This proposal is similar to provisions in Ohio law authorizing local governments to aggregate their residents on an "opt out" basis if approved by a majority vote of those residents on a general or primary election ballot. Locality aggregation in Ohio is subject to certain provisions, however, including the right of residents to "opt out" every two years without paying a switching fee.
 - b. The Maine Public Utility Commission recently conducted an auction to determine its "standard offer," i.e., generation service roughly the equivalent of "default service" in most states. It requested proposals to procure power on behalf of ratepayers for one year, hoping that eventually the market will become fluid enough so that individuals would shop on their own.
 - c. Under an agreement with the Public Utility Commission of Ohio ("PUCO"), First Energy (an Ohio incumbent electric utility) agreed to make available 1,120 MW of "Market Support Generation" to non-affiliated marketers, brokers and aggregators for sale to retail customers during a "market development period" that followed Ohio's introduction of retail competition. The capacity was made available on a first-come, first-served basis at prices set through negotiations with the PUCO staff and based on generation cost and wholesale market prices.

Responses

We believe that although the scenarios listed above appear to foster competitive activity, in reality they restrict competition in the competitive marketplace by the following:

- a. No customer choice; automatically switching customer to the locality preferred electric supplier.
- b. This program distorts the market by purchasing power on behalf of ratepayers; if the customers believed a competitive marketplace existed they would take advantage of the opportunity to reduce their energy cost.
- c. We would also note that our understanding is that the competition of a open market has failed to materialize in Ohio except to a minor extent in a northern portion of the state where costs were extremely high.

Q15. Are there any other actions that have been taken or are being considered in other states that may be used to advance competitive activity in Virginia?

KU is not aware of any other actions that could be taken to advance competitive activity in Virginia.

Q16. Do you have any ideas that have not been tried elsewhere that may facilitate competitive activity in Virginia?

Please see the response to Question 15.